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No. 06-43

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC.,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC..,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

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INTEREST OF THE *AMICUS CURIAE*[1]

For more than 100 years, the American Institute of Certified Public Accountants ("AICPA") has served as the national organization of the certified public accounting profession. The AICPA's nearly 340,000 members, all of whom are certified public accountants, provide accounting services to companies and individuals through firms of all sizes, and as solo practitioners. Its members also serve as employees of companies, and in the government and academia. Among the AICPA's most important roles is to promote and maintain high professional standards among its members. To this end, the AICPA has been a principal force in developing accounting and auditing standards, drafting model legislation, sponsoring educational programs, and issuing professional publications to improve the quality of the services provided by CPAs.

The AICPA has a strong interest in judicial decisions that affect the scope and bases of accountants' liability under the federal securities laws. Because they are seen as having "deep pockets" and may be among the few solvent parties remaining after a corporate collapse, CPAs provide attractive targets for securities fraud plaintiffs. To ensure that accountants can focus on serving clients rather than on defending against often baseless lawsuits, the AICPA has participated as *amicus curiae* in a wide variety of cases, including some of this Court's most significant securities fraud cases in each of the last four decades: *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007); *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336 (2005); *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994); *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988); and *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

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[1] The parties' letters of consent to the filing of this brief have been lodged with the Clerk. Pursuant to Rule 37.6 of the Rules of this Court, the AICPA states that no counsel for a party has authored this brief in whole or in part and that no person or entity, other than *amicus curiae*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief.

The Court's decision in *Central Bank*, holding that there is no private right of action for aiding and abetting a violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, is of paramount importance to the accounting profession. CPAs are paradigmatic "secondary actors," who for many years were sued under Section 10(b) not because they had committed a manipulative or deceptive act, but on the theory that they had assisted those who had. *Central Bank* put an end to such private actions. Since then, however, the plaintiffs' class action bar has tried to revive in several different guises the very claims that *Central Bank* held were unavailable. This case is the culmination of that misbegotten project. Because it is of manifest importance to the nation's CPAs to preserve the important limitations that Congress placed on Section 10(b) and Rule 10b-5, the AICPA submits this *amicus* brief.

INTRODUCTION AND SUMMARY OF ARGUMENT

The existence of a private right of action for aiding and abetting a violation of Section 10(b) was first recognized in *Brennan* v. *Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), and quickly became an entrenched, albeit unwarranted, staple of federal securities case law. Section 10(b) aiding and abetting liability had both criminal and tort law antecedents. See Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637, 646-47 (1988). According to Learned Hand's influential formulation, criminal aiding and abetting requires that the defendant must "in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed." *United States* v. *Peoni*, 100 F.2d 401, 402 (2d Cir. 1938); cf. *Landy* v. *Fed. Deposit Ins. Corp.*, 486 F.2d 139, 163-64 (3d Cir. 1973) (applying *Peoni* to Section 10(b)). Similarly, the Restatement of Torts, cited by many courts in the pre-*Central Bank* era, states that a person is liable for the conduct of another if he "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or

encouragement to the other so to conduct himself." *Brennan*, 259 F. Supp. at 680 (quoting RESTATEMENT OF TORTS § 876); see *Fed. Deposit Ins. Corp.* v. *First Interstate Bank of Des Moines, N.A.*, 885 F.2d 423, 429-30 (8th Cir. 1989).

From these sources, a common law of aiding and abetting liability under Section 10(b) eventually took shape. As generally articulated, such liability had three basic elements: (1) a securities law violation by the primary violator; (2) "knowledge" of this violation by the putative aider and abettor; and (3) "substantial assistance" by the aider and abettor in achieving the primary violation. Bromberg & Lowenfels, *supra*, at 662. "Substantial assistance" could take many forms, including aiding in the preparation of misstatements, financing transactions, or executing transactions on behalf of the principal. *E.g., Cumis Ins. Society, Inc.* v. *E.F. Hutton & Co.*, 457 F. Supp. 1380, 1386 (S.D.N.Y. 1978); see Bromberg & Lowenfels, *supra*, at 701-39.

In 1994, this judge-made legal structure came crashing down when this Court held that "the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation." *Central Bank*, 511 U.S. at 177. In so holding, the Court recognized that some secondary actors – including those who had knowingly participated in fraudulent activity – might escape Section 10(b) liability. The Court nevertheless concluded that its decision was compelled by the "text and structure" of Section 10(b). *Id.* at 188.

In the wake of *Central Bank*, Congress was persuaded by the SEC to codify aiding and abetting in the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104, but *only* for enforcement actions brought by the SEC itself. 15 U.S.C. § 78t(e). Like this Court, then, Congress made crystal clear that those who merely assist others in defrauding investors are not subject to private lawsuits under Section 10(b).

Central Bank left open the possibility that secondary actors "may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are

met." 511 U.S. at 191 (emphasis in original). Seizing that opening, the plaintiffs bar began to urge courts to liberalize the requirements for *primary* liability in an effort to revive, in a different guise, the very same aiding and abetting claims that *Central Bank* had foreclosed.

The present case illustrates that effort. Whereas *Central Bank* rejected as classic aiding and abetting such "secondary" activities as participating, enabling, facilitating, and advising, petitioner proposes to recharacterize the very same conduct as a "deceptive device or contrivance" under Section 10(b), or as either a "scheme to defraud" or as conduct "operat[ing] as a fraud or deceit" under Rule 10b-5. Such conduct, petitioner says, is a *primary* violation of the statute and the regulation (and not merely aiding and abetting), so long as it is undertaken with the "purpose and effect" of furthering the fraud.

These reformulations of ordinary aiding and abetting lack any grounding in the text of Section 10(b). As this Court's cases have made clear, Section 10(b) forbids *misstatements* (but only on the part of the person who actually *makes* the misstatement), *omissions* (but only by those who have a duty to disclose), and *manipulative conduct* (but only manipulations that, standing alone, mislead the market about the value of a security). Respondent is charged with none of these: It did not make the misstatement that allegedly deceived petitioner (Charter did so when it filed its financial statements); it did not make an actionable omission (as it had no duty toward petitioner); and its conduct was not a manipulation (since the transactions in which respondent engaged had no impact on the market unless and until Charter falsely accounted for them in its financial statements).

Petitioner's proposed reformulations are thus nothing but aiding and abetting in new bottles. Nor is it true that petitioner's "purpose and effect" test would separate *true* "primary liability" from mere aiding-and-abetting-style "primary liability." As we show below, that test is both unworkable and unwise.

Finally, permitting private actions to revive aiding-and-abetting liability under new labels would deter or raise the cost of professional services that are of great importance to the securities markets. When faced with the prospect of suit merely for rendering assistance to a company that might itself defraud investors, rational economic actors – such as certified public accountants – may choose to sit on the sidelines. And because of the enormous stakes of even modest-sized securities class actions, the professionals who *do* provide those services and *do* get sued will face "inordinate or hydraulic pressure" to settle before trial, regardless of the merits. *Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001). The costs dwarf the benefits and should not be tolerated.

The Court should affirm the Eighth Circuit's decision.

ARGUMENT

I. WHERE INVESTORS ARE INJURED BY AN ISSUER'S FALSE FINANCIAL STATEMENTS, LIABILITY UNDER SECTION 10(b) EXTENDS ONLY TO THOSE PARTIES WHO ACTUALLY MADE THE MISSTATEMENT

Most shareholder class actions follow a common pattern. Investors allege that a company made a false statement concerning the company's financial condition, either in an annual report, a quarterly report, or perhaps through a press release or an interview with an executive. Frequently, the plaintiffs sue the company's auditor as well, alleging that the auditor made a material misstatement in an audit report that accompanied the company's financial statements. Invoking the fraud-on-the-market theory articulated in *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), the plaintiffs argue that the misinformation artificially inflated the stock price, and that they were injured when the company's true financial condition was revealed. The plaintiffs seek damages under Section 10(b) for what they claim they lost on account of the fraud.

This case is typical. Petitioner, purportedly acting on behalf of all investors in the securities of Charter, alleges that Charter's public financial statements overstated the company's revenue and cash flow. Pet. Br. 3, 9. The false financial statements, according to petitioner, inflated the price of Charter's stock. *Id.* at 3. And when Charter revealed the true state of affairs and restated its financial statements, the market price of its securities declined and Charter's investors lost money. *Id.* at 9.

What makes the case noteworthy is not its fact pattern, but whom petitioner chose to sue. Not content to pursue the party that issued the financial statements, petitioner sought other deep pockets – specifically, two companies that entered into "phony" and "sham" transactions (Pet. Br. 3, 7), to which petitioner attributed part (but by no means all) of the errors in Charter's financial statements. Although the respondents are not alleged to have misstated their own financial statements – nor otherwise communicated in any way with the market regarding the transactions at issue – petitioners seek to hold them liable on the ground that respondents' *participation* in the underlying transactions makes them primarily liable under Section 10(b) for Charter's alleged misstatements.

Petitioner's argument contravenes the statutory text. If accepted, it would also revive, in only slightly different garb, the very liability theories rejected in *Central Bank*. For these reasons alone, the court of appeals should be affirmed.

A. Allowing A Misstatement Case To Be Recharacterized As A "Deceptive Conduct" Or "Scheme" Case Is Inconsistent With The Text Of Section 10(b) And With This Court's Decisions

1. This Court has long held that, to engage in "deception" under Section 10(b), one must make a "material misrepresentation or material failure to disclose." *Santa Fe Indus.* v. *Green*, 430 U.S. 462, 474 (1977). And in *Central Bank*, the Court squarely rejected the proposition that one can

be liable for a misrepresentation or failure to disclose merely by engaging in conduct that aids and abets that deception.

Petitioner and its *amici* seek to evade these limiting principles. Unhappy with the constraints imposed by the text of Section 10(b), petitioner and its *amici* urge the Court to focus instead on the text of Rule 10b-5. Pet. Br. 23-26; Brief of *Amici* States of Arkansas, New Jersey, *et al.* ("Sts. Br.") 2. Observing that the Rule proscribes any "device, scheme or artifice to defraud" (Rule 10b-5(a)), and any "act, practice, or course of business which operates * * * as a fraud or deceit" (Rule 10b-5(c)), petitioners contend that the Rule is broad enough to encompass the "scheme" or "deceptive conduct" they allege here after all. They argue that respondents' "acts," "schemes," and "practices" all violate the text of Rule 10b-5 – and thus Section 10(b) as well – *even though* respondents did not make the "material misrepresentation" (Charter's financial statements) that allegedly defrauded the market.

That attempt to leverage the language of Rule 10b-5 into a new private right of action fails, because it ignores the well-established principle that the text of Section 10(b), rather than that of the Rule, determines what conduct is prohibited. In *Central Bank*, the Supreme Court reiterated that "the private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)." 511 U.S. at 173. Determining the scope of the Rule therefore requires "close attention to the *statutory* text," *id.* at 169 (emphasis added), for "the language of the statute must control the interpretation of the Rule." *Santa Fe Indus.*, 430 U.S. at 472. The statute delimits the conduct proscribed, even if the Rule's language is susceptible of a more expansive interpretation. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214 (1976). Accordingly, any "scheme" or conduct "operat[ing] * * * as a fraud or deceit" must fit within – *not extend* – the statutory language.

Section 10(b) says nothing about "schemes" or "practices," but instead makes it unlawful for any person "to use or employ, in connection with the purchase or sale of any security * * * any

manipulative or deceptive device or contrivance * * *." 15 U.S.C. § 78j(b). In *Santa Fe Industries*, the Court explained that a plaintiff "states a cause of action under *any* part of Rule 10b-5 *only* if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute.'" 430 U.S. at 473-474 (emphases added). The Court then addressed the meaning of both of these crucial terms.

"'Manipulation' is 'virtually a term of art when used in connection with securities markets.' The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Id.* at 476 (quoting *Hochfelder*, 425 U.S. at 199). To be "manipulative" under Section 10(b), the defendant's conduct must "inject[] inaccurate information into the market or create[] a false impression of market activity." *GFL Advantage Fund, Ltd.* v. *Colkitt*, 272 F.3d 189, 205 (3d Cir. 2001) (internal quotations omitted). In other words, the manipulation must *itself* distort the market in a way that would mislead investors.

As for "deception," the Court in *Santa Fe Industries* held that, because "the complaint failed to allege a material misrepresentation or material failure to disclose," there was no allegation of "deceptive" conduct with the meaning of Section 10(b). 430 U.S. at 474. Accordingly, the deceptions proscribed by the statute – and thus by Rule 10b-5 – involve the dissemination of false information (or the failure to disseminate truthful information in the face of a duty to do so). *Central Bank* reaffirmed that basic understanding: "As in earlier cases considering conduct prohibited by §10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." 511 U.S. at 177.

Respondents' alleged conduct in this case falls into neither of those categories. Their actions plainly were not market "manipulations" that "artificially affect[ed] market activity," and petitioner does not contend otherwise. Neither was their

alleged conduct a "deception," because respondents did not make the "material misrepresentation or material failure to disclose" that petitioner contends defrauded the market. *Santa Fe Indus.*, 430 U.S. at 474, 476. According to petitioner, it was *Charter's financial statements* that defrauded investors. See, *e.g.*, Pet. Br. 21 (Defendants' conduct "cause[d] the publication of artificially inflated financial statements to investors"), *id.* at 40 ("transactions were reflected in Charter's financials"); Sts. Br. 13 ("The plaintiffs in this action claim that they were defrauded by Charter's false reports of revenues and cash flows.").

Petitioner argues (Br. 31) that "conduct" – unaccompanied by either a misstatement or a failure of a duty to disclose – can constitute a "deception" under the statute. But neither *SEC* v. *Zandford*, 535 U.S. 813 (2002), nor *United States* v. *O'Hagan*, 521 U.S. 642 (1997), on which petitioner relies, support such a broad proposition. In those cases, the defendant committed deception by misappropriating funds (*Zandford*) or confidential information (*O'Hagan*), *while fraudulently omitting to disclose the act in breach of a fiduciary duty.* In both cases, the Court made clear that it was the defendant's "material failure to disclose" that gave rise to liability for "deception." See *O'Hagan*, 521 U.S. at 660 ("deceptive nondisclosure is essential to the § 10(b) liability at issue"; "it was O'Hagan's failure to disclose * * * that made his conduct 'deceptive' within the meaning of § 10(b)") (alterations omitted); *Zandford*, 535 U.S. at 1906 n.4 (had Zandford merely "told his client he was stealing the client's assets * * * it would not [have] involve[d] a deceptive device or fraud").

This "failure to disclose" theory of deception is of no help to petitioners. First and foremost, petitioners do not claim that they were defrauded by respondents' (or by anyone's) non-disclosure; they allege that they were defrauded by Charter's false financial statements. And in any event, as *Zandford* and *O'Hagan* make clear, a failure to disclose a fraud may violate the statute *only* when the failure breaches a fiduciary duty to disclose. Notwithstanding the States' argument (Sts. Br. 19-22),

mere "participation" in a fraud does not by itself give rise to a freestanding duty to disclose the fraud to the public. If it did, *Central Bank* would have come out the other way. See *Chiarella* v. *United States*, 445 U.S. 222, 232-33 (1980) (reversing insider trading conviction under Section 10(b) because defendant was not party to an agency or other fiduciary relationship that gave rise to a duty to disclose).

At bottom this is a simple misstatement case. Charter's allegedly misleading financial statements are paradigmatic false statements actionable under Rule 10b-5(b). They are what the market relied upon in overvaluing Charter securities, and thus what petitioner relied on in deciding to invest. In contrast, the revenue-generating transactions between Charter and respondents merely "enabled" Charter's alleged deception (Pet. Br. i) by helping to establish background conditions against which the misstatements were made. By allegedly engaging in conduct that did not *itself* deceive investors (but merely made the issuer's misstatements easier to prepare), respondents' status is (at most) that of aiders and abettors. To allow the claims against respondents to proceed under a "scheme" theory would resurrect the very kind of liability precluded by *Central Bank* and would permit virtually anything that once constituted aiding and abetting to become actionable by relabeling it as a "scheme."

2. Subjecting respondents to liability under Rule 10b-5(a) or (c) would subvert not only the core holding of *Central Bank*, but also the reasoning the Court used to get there. The Court made clear that it was rejecting aiding and abetting liability in order to implement Section 10(b)'s reliance requirement:

> A plaintiff must show reliance on the defendant's misstatement or omission to recover under 10b-5. Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions.

511 U.S. at 180 (internal citation omitted). The decision not to read aiding and abetting liability into Section 10(b) thus sprung, at least in part, from the Court's unwillingness to allow a defendant to be held liable without a showing that its *own* actions induced the plaintiff to invest.

Yet the theory of liability propounded by petitioners and their *amici* here would have precisely that effect. As the court of appeals observed (Pet. App. 10a), petitioner purchased Charter securities in reliance on the company's alleged misstatements – not in reliance on the allegedly "phony" transactions in which respondents engaged. Allowing petitioners to recover against those defendants would undermine the bedrock requirement that reliance must be proven as to the actions or statements of each defendant individually. Accordingly, petitioners' notion (Pet. Br. 20) that a plaintiff who relies on a misstatement thereby relies on the actions of every party who played some antecedent role in helping that misstatement come into life is precisely what *Central Bank* rejected.

3. Section 10(b) makes it unlawful "[t]o *use or employ*" a deceptive device or contrivance in connection with the purchase or sale of a security. 15 U.S.C. § 78j(b) (emphasis added). To "use" or "employ" a "deceptive device" means to "convert [it] to one's service," or "to avail oneself of" it. *Bailey* v. *United States*, 516 U.S. 137, 145 (1995). It follows that a party cannot be liable under the statute on the basis of a deceptive device that *somebody else* "convert[ed] to [his] service" or to which *somebody else* "avail[ed]" himself.

According to petitioner's own allegations, it was Charter's financial statements that misled investors. See, *e.g.*, Pet. Br. 21. And the only party that "used" or "employed" those financial statements was Charter itself, which published and filed them with the SEC. There is no credible argument – nor do petitioner or its *amici* so contend – that respondents "used" or "employed" Charter's financial statements.

Petitioner nevertheless urges that the inclusion of the word "indirectly" in Section 10(b) ("It shall be unlawful for any person, directly or *indirectly*, by the use of any means or instrumentality of interstate commerce or of the mails * * * to use or employ * * * any manipulative or deceptive device or contrivance * * *") means that "all those who engage in deceptive conduct" may be liable under Section 10(b), even if it is somebody else who defrauds the plaintiff. Pet. Br. 20. The States refine the argument, contending that Section 10(b) prohibits parties from "using another person as a 'conduit' to communicate false information to the market." Sts. Br. 22-29.

Even if the word "indirectly" modifies the phrase "use or employ" (as opposed to modifying the statute's jurisdictional clause), it does not deliver the result petitioner and its *amici* hope for. The cases cited in the States' brief stand for the unremarkable proposition that a defendant "cannot escape liability simply because it carried out its alleged fraud through the public statements of third parties." Sts. Br. 23 (quoting *Cooper* v. *Pickett*, 137 F.3d 616, 624 (9th Cir. 1997)). It is true, of course, that a defendant who whispers his fraudulent misinformation to a "conduit," intending that the conduit will disseminate the information about the defendant (and on his behalf) is not insulated from Section 10(b) simply because he used an intermediary.

But petitioner wants the word "indirectly" to extend liability, as well, to someone who has at most facilitated somebody *else's* ability to make his *own* misstatement directly to the public. Under those circumstances, the facilitator cannot be said to have "indirectly" *made* a misstatement. To the contrary, "[a]llegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms * * * all fall within the prohibitive bar of *Central Bank*." *Shapiro* v. *Cantor*, 123 F.3d 717, 720 (2d Cir. 1997).

In this case, respondents did not enlist Charter to report false information about *respondents'* financial condition. Charter's financial statements did not disclose, for example, that

Charter had entered into an equipment-for-advertising deal with respondents that would result in respondents earning a certain amount of revenue. Charter's financial statements did not even mention the respondents, the transactions with respondents, or any other information about respondents. It therefore cannot be said that *respondents* were making a statement of any kind through the issuance of Charter's financial statements, whether "directly" or "indirectly." For the same reasons, auditors who merely consult with clients regarding the structure or reporting of transactions, are not liable under Section 10(b) – either directly or indirectly – in the event the company makes a public misstatement.

B. Petitioner's "Purpose And Effect" Test Does Not Successfully Distinguish Garden-Variety Aiding And Abetting From True "Primary Liability"

In an effort not to revive *all* classic aiding and abetting claims, petitioner proposes to charge as primary liability only conduct that is committed with the "purpose and effect" of creating a false appearance of material fact in furtherance of a scheme to defraud. The Ninth Circuit has already adopted a similar standard, holding that a defendant may be held liable as a primary violator under Section 10(b) if it engaged in conduct that "had the *principal* purpose and effect of creating a false appearance of fact in furtherance of the scheme." *Simpson* v. *AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006) (emphasis added), *petition for cert. filed subnom. Calif. St. Teachers Ret. Sys.* v. *Homestore.com, Inc.*, 75 U.S.L.W. 3236 (U.S. Oct. 19, 2006) (No. 06-560).

The purpose and effect test utterly fails to distinguish garden-variety aiding and abetting from primary liability. After all, aiding and abetting *presupposes* that the secondary participant had the same "purpose," and caused the same "effect," as the primary violator. Indeed, under pre-*Central Bank* case law, an alleged aider and abettor could be held liable only if he acted with the purpose and effect of helping someone else violate the securities laws. See *Schatz* v. *Rosenberg*, 943

F.2d 485, 496 (4th Cir. 1991) (aiding and abetting generally requires a "conscious and specific motivation to aid the fraud"); *Renovitch* v. *Kaufman*, 905 F.2d 1040, 1045-46 (7th Cir. 1990) (internal quotation omitted); *Edwards & Hanly* v. *Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 485 (2d Cir. 1979). And this is hardly surprising, since aiding and abetting under Section 10(b) derived from accomplice liability under the criminal law, under which the accomplice must have acted "with the knowledge and intention" of helping the principal commit the crime. *United States* v. *Sayetsitty*, 107 F.3d 1405, 1411 (9th Cir. 1997); see 1A FED. JURY PRAC. AND INSTR. § 18.01 (5th ed. 2000).

From the standpoint of investors in the securities markets, moreover, a transaction whose purpose is the creation of false revenues is entirely indistinguishable from one whose purpose is *not* to do so. Investors are no more deceived by the former than by the latter. In neither case can the transaction have *any* effect on the market unless and until a third party decides to record its proceeds in a misleading way. The purpose and effect test thus misses the true distinction between primary liability and aiding and abetting, which is that a primary defendant must be culpable – in the sense of actually defrauding investors or the market – based on its *own* actions, rather than as a result of the conduct or statements of someone else. The *purpose* of the transaction ("primary" or otherwise) simply does not provide a principled basis on which to distinguish actual violations of Section 10(b) from mere aiding and abetting.

Finally, a "purpose and effect" test would be exceeding difficult to apply: How do we know what the "purpose" of any particular transaction is? One of the reasons that this Court rejected aiding and abetting liability in *Central Bank* was that "the rules for determining * * * liability are unclear, in 'an area that demands certainty and predictability.'" 511 U.S. at 188, quoting *Pinter* v. *Dahl*, 486 U.S. 622, 652 (1988). Such uncertainty and unpredictability "leads to the undesirable result of decisions 'made on an *ad hoc* basis, offering little predictive value' to those who provide services to participants in the

securities business." *Ibid.*, quoting *Pinter*, 486 U.S. at 652. This Court concluded that "such a shifting and highly fact-oriented disposition" was "not a satisfactory basis for a rule" governing the standards for 10b-5 actions. *Ibid.*, quoting *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 755 (1975). The "purpose and effect" test suffers from the same deficiencies.

The Court should make clear that the "schemes" or "deceptive conduct" covered by Rules 10b-5(a) and (c) are those that *of their own accord* distort the market or deceive investors. Conduct that does so only because another party uses it to make a public misstatement is neither a manipulation nor a deception under the statute.

II. EXTENDING LIABILITY FOR FALSE STATEMENTS TO PERSONS WHO DID NOT MAKE THEM WOULD IMPAIR THE QUALITY OF FINANCIAL REPORTING BY PUBLIC COMPANIES

Before an accounting firm issues a report on a public company's financial statements, it must perform an audit, the elements of which are prescribed by an extensive body of rules and regulations. Only after completing the required steps does an auditor publicly attest to the sufficiency of the audit procedures and the quality of the company's financial statements. Accounting firms are well aware that their affirmative representations about the audits they perform and about the quality of their audit clients' financial statements – if false – can give rise to crippling liability under the federal securities laws. As a consequence, auditors have every incentive to carry out a rigorous audit – typically an expensive and laborious project – before affixing their firm's name to the audit report that accompanies the client's audited financial statements.

Under the "purpose and effect" test advocated by petitioner, however, an auditor who conducts a limited review of a client's *unaudited* filings or public statements, or provides informal advice about the structure of a pending transaction, is likely to

become a new target for class-action counsel carrying the banner of "scheme liability." And if auditors face the prospect of bet-the-firm litigation based on a peripheral connection to statements they have not made, and transactions they have not audited, every auditor's relationship with its public company clients will be changed for the worse. The inherent murkiness of a "purpose and effect" standard would make dismissal on the pleadings of even meritless claims sufficiently uncertain as to require auditors to raise the cost of such services, or even decline to perform them altogether. All of that would make the overall quality of financial reporting worse, not better.

The vagaries of Section 10(b) litigation are so great that the regime petitioners propose may well cause auditors to "act in ways that will avoid not simply conduct that the securities law forbids * * * but also a wide range of * * * conduct that the securities law permits or encourages." *Credit Suisse Securities (USA) LLC* v. *Billing*, 127 S. Ct. 2383, 2396 (2007).[2] As a result, rational auditors may conclude that the safest course is to have nothing to do with any transaction or statement by a public company that has not been subjected to a formal audit. And the burden of that chilling effect would fall most heavily on the smaller and newer companies, as well as those operating in volatile industries such as technology, that have the greatest need for the types of services most likely to be branded as "schemes" by plaintiffs' lawyers. The rule petitioners propose would invite a new generation of claims that carry the threat of limitless liability. The Court should not issue that invitation.

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[2] See S. Rep. No. 104-98, at 9 (1995) (noting that "[u]nderwriters" and "other professionals are prime targets of abusive securities lawsuits" and that "[t]he deeper the pocket, the greater the likelihood that a marginal party will be named as a defendant").

A. The Open-Ended "Purpose And Effect" Test Would Dissuade Auditors From Performing Services That Are Beneficial To Public Companies And Their Investors

1. The annual financial statements that every public company files with the SEC must be audited by a certified public accountant. See 15 U.S.C. § 78j-1 (mandating and setting standards for annual audit). An "audit" is a term of art, and its performance, from conception to completion, is governed by an extensive body of detailed requirements. The subject of the audit – the company's annual financial statements – must be prepared by the company in accordance with an equally detailed set of requirements. In most cases, after the auditor completes the audit, it issues an audit report, in which it makes two very specific public statements, one about the audit, and one about the audited financial statements.

First (in the case of domestic public companies), the auditor represents that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB").[3] Second, in the event an "unqualified" opinion is warranted, the auditor represents that the audit provides a "reasonable basis" on which to opine that the financial statements "present fairly, in all material respects, the financial position of [the] company," and "the results of its operations and its cash flows for the years then ended in conformity with" Generally Accepted Accounting Principles (GAAP).

Courts have long held that both portions of the audit report are "statements" for purposes of Section 10(b), and that either statement, if knowingly false (and if all the other requirements of Section 10(b) are satisfied), may be actionable in a private securities action. See, *e.g.*, *Lattanzio* v. *Deloitte & Touche LLP*, 476 F.3d 147, 153 (2d Cir. 2007). Indeed, it is only

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[3] The PCAOB has effectively adopted the Generally Accepted Auditing Standards (sometimes known as GAAS) promulgated by the AICPA.

through the act of issuing an opinion on the company's financial statements that "the independent auditor assumes a *public* responsibility transcending any employment relationship with the client." See *United States* v. *Arthur Young & Co.*, 465 U.S. 805, 817 (1984) (emphasis in original). It is precisely because of the practical and legal significance of the audit report that audits of large public companies are typically such laborious and expensive undertakings. Understandably, auditors are (and should be) unwilling to affix their firm's name to an audit report without first having carried out the steps that the PCAOB prescribes.

2. But a financial statement audit is not the only important task that auditors perform for their public company clients. Auditors commonly render a variety of other services that do *not* require the planning and performance of a formal audit, and that do *not* culminate in the issuance of a publicly filed statement by the auditor.

For example, auditors typically perform a "review" of their client's quarterly, or interim, financial statements – a procedure that is far more limited in scope than an audit of the annual financial statements. See 17 C.F.R. § 210.10(d) (mandating review); Statement on Auditing Standards ("SAS") 100 (setting out standards for review). Unlike an audit, a review is designed for the limited purpose of communicating to the client whether the auditor has become aware of any "material modifications" that should be made to the financial statements in order to comply with GAAP. D. R. CARMICHAEL, O. RAY WHITTINGTON & LYNFORD GRAHAM, ACCOUNTANTS' HANDBOOK, § 15.5(b) (11th ed. 2007) (hereinafter "ACCOUNTANTS' HANDBOOK"); see also, MICHAEL J. RAMOS, PRACTITIONER'S GUIDE TO GAAS at 549 (2006) (hereinafter "PRACTITIONER'S GUIDE"). Significantly, federal regulations are clear that an accountant is not required to file a report with quarterly financial statements. See 17 C.F.R. § 210.10(d).[4]

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[4] Under the federal regulations, an auditor must issue a report *only* if

Since *Central Bank*, courts have consistently rejected attempts by class action counsel to sue auditors on the basis of alleged misstatements in their clients' unaudited quarterly filings. See *Wright* v. *Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *In re IKON Office Solutions, Inc. Sec. Litig.*, 131 F. Supp. 2d 680, 685 n.5 (E.D. Pa. 2001); *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp 26, 28 (D. Mass. 1994); *In re Seracare Life Sciences, Inc. Sec. Litig.*, No. 05-CV-2335-H (CAB), 2007 WL 935583, at *10 (S.D. Cal. Mar. 19, 2007).

Under the expansive liability regime advocated by petitioner, however, it would be a simple matter for inventive plaintiffs' counsel to extend Section 10(b) liability to auditors on the basis of unaudited statements. First, counsel would assert that the company fraudulently accounted for some transaction in its quarterly financial statements. Next, counsel would allege that the company's auditor knowingly overlooked or approved of the fraud during the quarterly review, all with the "purpose and effect" of enabling the fraudulent "scheme." Experience teaches that the heightened pleading requirements of the PSLRA would be cold comfort in the face of such claims; if auditors were exposed to liability based on their clients' unaudited financial statements, they would be well advised to perform the procedures associated with an *audit* every quarter.[5]

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the interim financial statements explicitly refer to the auditor's review. See 17 C.F.R. § 210.10(d). And, even when a report is filed in connection with a quarterly financial statement, that report does not give a positive assurance that the statements comply with GAAP, as does an audit opinion. Instead, the report provides only the negative assurance that the auditor is not aware of any material modifications that should be made to the financial statements. See PRACTITIONER'S GUIDE at 563-64.

[5] The quarterly review function, though more limited in scope than an audit, serves a valuable purposed. The review "is procedurally integrated into the company's year-end audit and thereby tends to reduce sharp variations and year-end surprises by spreading

3. The expansive liability that petitioners propose also would encourage plaintiffs' counsel to sue auditors based on contacts that are even less involved than a quarterly review. Throughout the year, public companies consult with auditors to discuss the accounting ramifications of various business decisions. Auditors often attend meetings to discuss potential transactions. Such interaction assists the client in understanding how the transaction will affect its financial statements and helps the client determine whether to do the transaction and how it should be structured. Similarly, auditors often respond to telephone inquiries from clients requesting advice on the accounting treatment of proposed business decisions.

But if auditors may be subject to suit based on allegations that even the briefest conversation was part of a scheme to defraud, they may hesitate to interact with the client until the performance of year-end audit procedures. This would be a disservice to both the client and its shareholders. The client may well refrain from entering into a transaction or making a strategic business move if it does not have any guidance as to the accounting implications of its decision. And, if the company does take action but initially accounts for it incorrectly, there will be larger corrections – or "year-end surprises" (*Lattanzio*, 476 F.3d at 156) – in the annual financial statements.

4. Finally, audit firms also provide advice to non-audit clients. A company may seek a second opinion from an accounting firm that is not its auditor on the accounting treatment for a proposed transaction that raises novel or undecided accounting issues. This kind of engagement, which is recognized by the accounting literature,[6] allows issuers to

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corrections throughout the year." *Lattanzio*, 476 F.3d at 156 (citing Professionals Issues Task Practice Alert 2000-4, *Quality Review Procedures for Public Companies*).

[6] SAS 50, as amended by SAS 97, governs the issuance of letters addressing proposed transactions to non-audit clients.

consider numerous alternatives for reporting on new and emerging issues. PRACTITIONER'S GUIDE at 494. Again, however, adoption of "purpose and effect" scheme liability would be seized upon by the plaintiffs' bar as a basis for alleging that the advice had the "purpose and effect" of falsifying the company's financial statements. In that world, firms could be expected to refuse these engagements.

5. Once liability for deception under Section 10(b) is untethered from any requirement that the defendant make a public misstatement, there will be a chilling effect on the performance by auditors of services that are beneficial to companies and their shareholders. In the years immediately preceding passage of the PSLRA, it was well documented that rampant class action litigation against CPAs made accounting firms increasingly unwilling to perform audits for clients perceived as risky, such as those in financial distress, smaller or less-well established companies (including start-ups), and companies operating in volatile industries such as technology. See Frederick L. Jones & K. Raghunandan, *Client Risk and Recent Changes in the Market for Audit Services*, 17 J. ACCT. & PUB. POL'Y 169, 179 (1998).

A shrinking supply forces companies with fewer resources to absorb higher prices for legally required financial audits.[7] Such high-risk firms are particularly dependent upon the imprimatur of a well-established, well-respected auditor in order to gain the confidence of the market. Depriving them of quality auditing services makes it more difficult for the growth sectors of the economy to develop to their full potential. *Central Bank*, 511 U.S. at 189. For, even where litigation risk does not cause CPAs to forego providing professional services, they will typically insist on higher fees to high-risk clients,

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[7] Audit fees for Fortune 500 companies increased by more than 100% from 2001 to 2004. See Jack T. Ciesielski & Thomas R. Weinrich, *Ups and Downs of Audit Fees Since the Sarbanes-Oxley Act*, THE CPA JOURNAL (October 2006) (reprinted at www.nysscpa.org/-printversions/cpaj/2006/1006/p28.htm).

costs that the client companies will undoubtedly attempt to pass on to consumers. See Jamie Pratt & James D. Stice, *The Effects of Client Characteristics on Auditor Litigation Risk Judgments, Required Audit Evidence, and Recommended Fees*, 69 ACCT. REV. 639, 655 (1994).

B. Auditors Are Especially Vulnerable To Vexatious Securities Class Actions, And Thus Stand To Be Disproportionately Harmed By The Rule Advocated By Petitioner

Auditors are particularly attractive targets in securities class actions for a number of reasons. First, application of the conventions, rules, and procedures that collectively constitute accepted accounting practices requires substantial professional judgment. "[A]uditing is not a mechanical process, and an audit report is not an objective statement of fact." Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. U. L. REV. 17, 54 (2003).[8] And, GAAP is not "a canonical set of rules that will ensure identical accounting treatment of identical transactions," but instead "tolerate[s] a range of 'reasonable' treatments * * *." *Thor Power Tool Co.* v. *Commissioner of Internal Revenue*, 439 U.S. 522, 544 (1979).

An "expectations gap" therefore persists between what CPAs expect of their work and what the public (and often the courts) expect. See Richard I. Miller & Michael R. Young, *Financial Reporting and Risk Management in the 21st Century*,

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[8] An audit is designed to provide a *reasonable* basis for the auditor to express an opinion on the client's financial statements taken as a whole. ACCOUNTANTS' HANDBOOK § 15.5 at 16. (emphasis added). An "audit does not guarantee that a client's accounts and financial statements are correct any more than a sanguine medical diagnosis guarantees well-being; indeed, even an audit conducted in strict accordance with professional standards countenances some degree of calibration for tolerable error which, on occasion, may result in a failure to detect material omission or misstatement." *In re IKON Office Solutions, Inc.*, 277 F.3d 658, 673 (3d Cir. 2002).

65 FORDHAM L. REV. 1987, 2016 & n.129 (1997). This gap contributes to an environment in which investors are likely to blame auditors for unforseen corporate collapses and to sue them when they occur. The allegation that a CPA ran afoul of some aspect of the general rules of GAAS or failed to identify one of the myriad potential GAAP violations is easy to make and difficult to rebut. Courts routinely invoke such alleged violations in sustaining claims against auditors. See, *e.g.*, *Rhode Island Hosp. Trust Nat'l Bank* v. *Swartz*, 455 F.2d 847, 852 (4th Cir. 1972); *In re Ancor Communications, Inc.*, 22 F. Supp. 2d 999, 1005-06 (D. Minn. 1998); *In re Miller Indus., Inc. Sec. Litig.*, 12 F. Supp. 2d 1323, 1332 (N.D. Ga. 1998). Especially in a declining market, where the bursting of a bubble leaves many investors with significant losses, bringing suit against an auditing firm based on an allegedly deficient audit can be an easy way to try to recoup those losses.

Second, CPAs are inviting, "deep pocket" targets for expansive notions of securities fraud liability. In the wake of a corporate failure, the auditor is often the last one standing. In many cases, the issuer responsible for the allegedly misleading financial statements has gone bankrupt or become otherwise judgment-proof, leaving the CPA as the only entity from which plaintiffs can hope to recover their investment losses. See Daniel L. Brockett, *Line Between Primary and Secondary Liability Still Blurred in Securities Cases*, 50 FED. LAW. 29, 30 (2003). Indeed, between 30 and 40 percent of securities fraud cases against auditors involve companies that are in, or about to enter, bankruptcy. See Zoe-Vonna Palmorose, *Who Got Sued?* J. OF ACCOUNTANCY ONLINE (March 1997), available at www.aicpa.org/pubs/jofa/march97/whosued.htm. Thus, despite having played only a secondary role – that may consist of little more than reviewing allegedly misleading financial statements, or merely answering an accounting question on a quick phone call – accounting firms frequently emerge as the lone defendant financially able to satisfy a potential judgment. See Feinman, 31 FLA. ST. U. L. REV. at 57.

Given their exposure to potentially vast liability, as well as their concern for their professional reputations, accounting firms may be forced to settle even where the merits of a suit are dubious. Against this backdrop, confining "deception" liability only to those defendants who actually *made* a deceptive misstatement guards against the prospect that auditors will be made to cover investment losses for which their actions were not in fact responsible. Conversely, expanding Section 10(b) liability in the manner petitioner suggests would move the securities laws closer to what they were never intended to be: a form of cost-free insurance for disappointed investors. See *Dura Pharmaceuticals*, 544 U.S. at 344.

Failure to adhere to the statutory text – thereby opening the door to a new wave of lawyer-driven litigation – would have serious consequences for the already-beleaguered accounting profession. Securities litigation is extremely costly, *regardless* whether the underlying claim has the slightest merit. One study found that it costs an auditor an average of $3.7 million to defend itself against even a weak securities fraud class action. See Palmrose, *supra*.

Class action litigation against accounting firms did decrease in the first years after passage of the PSLRA, a trend undoubtedly helped by this Court's holding in *Central Bank*. See SEC, Office of the Gen. Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 22 (Apr. 1997), available at www.sec.gov/news/studies/lreform.txt. More recently, however, there has been a resurgence in litigation alleging accounting fraud and targeting CPAs. In 2006, accounting-related cases represented 60 percent of all private securities class actions, up from 48 percent in 1996. PricewaterhouseCoopers LLP, *2006 Securities Litigation Survey*, at 8-9. Accounting-related settlements represented the majority of the largest securities fraud settlements, totaling 93 percent of all securities-related settlement amounts in 2006. *Id.* at 31-33. It has thus been accurately observed that accounting fraud seems to have become "the 'complaint of choice' for

private securities class action plaintiffs." Pricewaterhouse-Coopers LLP, *2002 Securities Litigation Survey*, at 4.

Empirical studies have also shown that litigation against an audit firm – even, or perhaps especially, frivolous ligation – hurts the stock price of an auditor's *other* clients. See Diana R. Franz, et al., *The Impact of Litigation Against an Audit Firm on the Market Value of Nonlitigating Clients*, 13 J. ACCT. AUDITING & FIN. 117 (1998).

Finally, the expansive – and non-textual – construction of Section 10(b) advocated by petitioner is all cost and no benefit: There is simply no reason to fear that rejecting "purpose and effect" liability will somehow create a gap in the enforcement of the securities laws. The SEC is authorized to bring enforcement actions against aiders-and-abettors. See 15 U.S.C. § 78t(e). The federal government thus always retains the power to take action against individuals and firms that knowingly and substantially assist fraud proscribed by the federal securities statutes, regardless of whether any particular investors suffered financial harm as a result of that fraud. There is neither need nor reason to extend that expansive law enforcement power to private plaintiffs. To the contrary, doing so could effectively delegate wide-ranging enforcement power to unaccountable plaintiffs' lawyers, trenching on the SEC's prosecutorial discretion.

The States miss the mark when they argue (at 8) that private litigation is necessary to supplement SEC enforcement actions. Although it has been noted that, in certain circumstances, private lawsuits serve a valuable role, Congress was explicitly asked to reverse *Central Bank* with regard to both private plaintiffs and the SEC. See S. Rep. No. 104-98, at 48-49 (1995). Congress elected to restore such liability *only* when the SEC is the plaintiff. See 15 U.S.C. § 78t(e). Petitioner should not be permitted to circumvent Congress' judgment by slapping a new name on aiding and abetting cases.

CONCLUSION

For the foregoing reasons, the judgment of the Eighth Circuit should be affirmed.

Respectfully submitted.

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